

The Manager  
Business R&D  
Small Business Entities & Industry Concessions Unit  
The Treasury  
Delivered via email: RnDamendments@treasury.gov.au

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Dear Sir/Madam

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**Submission: Proposed Legislative Amendments titled ‘Better targeting the Research and Development Tax Incentive’.**

Swanson Reed has previously emphasised the important role of the R&D Tax Incentive for encouraging investment in R&D activities within previous consultation submissions:

- 2016 R&D Tax Incentive Review and associated reports;
- 2015 Tax White Paper (Re:Think);
- 2014 Senate Inquiry into Australia’s Innovation System.

Enclosed is our submission regarding the currently proposed amendments to the R&D Tax Incentive. The content of this submission is focussed on the questions raised in the consultation paper, along with specific concerns we have with respect to some aspects of the legislative package.

**About Swanson Reed**

Swanson Reed is a leading specialist R&D tax advisor that services a wide spectrum of clients in various locations throughout Australia. In addition to chartered accountants, Swanson Reed’s team includes technical personnel with backgrounds in engineering, science and law.

Since May 2009, Swanson Reed has conducted over 400 workshops on the R&D Tax Incentive and Concession. The workshops have identified that nearly all participants in the programme are concerned that the R&D Tax Incentive will be subject to further cuts in the future, which reduces the willingness of companies to invest in R&D and innovation.

Swanson Reed is of the view that stable and generous support for R&D must be maintained to give companies confidence to invest in long-term innovation strategies. The R&D Tax Incentive is still in its

relative infancy, and amendments focused on reducing budgetary cost would further reduce confidence in the programme following previous legislative measures. Swanson Reed urges any changes to the R&D Tax Incentive to be carefully considered, so as not to disrupt confidence in the programme.

### ***Concerns about proposed introduction date of changes***

Swanson Reed is concerned that the proposed introduction date for income years starting on or after 1 July 2018 (FY19) is not suitable given that:

- The draft legislation detailing the proposed changes was not available until 29 June 2018;
- It may yet be a number of months before the legislation is passed as law, if the bill does indeed pass the Senate.

As it is considered bad policy to enact tax changes retrospectively, an introduction date of FY19 is not appropriate given that any enacting of the amendments as law would not happen until well after 1 July 2018.

The need for companies to have sufficient time to be consulted on and understand the proposed changes is particularly important in this case as:

- The R&D Incentive is a policy instrument designed to encourage long-term investment in R&D. Companies have previously made project investment decisions based on the availability of the current fixed rate of R&D Tax Offset entitlements;
- The proposed amendments are significant, particularly with respect to the application of the Intensity Threshold. Up until the availability of the draft legislation on 29 June 2018, there was significant uncertainty as to how the Intensity Threshold may apply, such as whether it may include COGS expenses.

Companies need appropriate time to understand and plan for the proposed significant changes to the R&D Tax Incentive.

A proposed introduction date for income years starting on or after 1 July 2019 (FY20) would be more suitable.

### ***Calculation of the Refundable R&D Tax Offset***

Swanson Reed notes that the proposed amendments change the determination of a company's Refundable R&D Tax Offset whereby:

- Currently the rate of the Refundable R&D Tax Offset is fixed at 43.5%;
- The rate of the Refundable R&D Tax Offset is proposed to change to a rate based on a company's corporate tax rate plus a premium of 13.5%.

This change represents a significant decline in the Refundable R&D Tax Offset and does not seem to have been given sufficient coverage since the proposed changes were announced in the May 2018 budget.

Companies with surplus tax losses currently receive a 43.5% Refundable R&D Tax Offset. However, under the proposed changes:

- For the FY19 period, eligible companies would receive a refundable R&D tax offset of 41% (company tax rate of 27.5% + 13.5% premium);
- When the company tax rate declines further in the future as is proposed, the Refundable R&D Tax Offset entitlement would also decline further.

Continued deterioration of R&D tax benefit:

We note that the proposed change will represent another decline in the magnitude of the Refundable R&D Tax Offset for companies in tax loss.

Since the introduction of the R&D Tax Incentive in FY12 offering a 45% refund for eligible expenditure of companies with surplus tax losses, there have now been multiple reductions, including:

- Reduction in the Refundable Offset from \$0.45 to \$0.435 (*Budget Savings (Omnibus) Bill 2016*);
- Reduction in the Refundable Offset from \$0.435 to \$0.41 (*Treasury Laws Amendment (Research and Development Incentive) Bill 2018*);
- Further future reduction in the Refundable Offset from \$0.41 if the company tax rate reduces as is planned (*Treasury Laws Amendment (Research and Development Incentive) Bill 2018*).

Ongoing deterioration of the Refundable R&D Tax Offset reduces the ability of companies to be confident in the R&D Tax Incentive and may particularly harm critical, high tech industries such as life sciences or ICT.

Cap on refundable R&D tax offsets:

As noted in our previous submissions, Swanson Reed acknowledges a cap on the Refundable R&D Tax Offset may be warranted if such a cap facilitates future legislative stability of the programme.

As a transition measure, we would recommend that any companies that may have active findings from ISA for future activities with expenditure forecast to be in excess of the proposed cap should still be able to access the approved R&D Offset entitlement.

Swanson Reed also wishes to commend the government's design of the cap in respect of:

- Incorporating measures to exempt clinical trial activities from the cap;

- Not introducing a lifetime cap per company, which was proposed as an option during the R&D Tax Incentive review process.

***Increase of expenditure cap for companies with very large R&D expenditure***

Swanson Reed is relatively neutral with respect to the proposal that the current cap on eligible R&D expenditure be increased from \$100M to \$150M.

We would suggest that analysis be undertaken following the implementation of this change and that if the impact were to be that the majority of capped companies merely go from reporting \$100M of annual eligible R&D expenditure to \$150M:

- The increased cap is not having the desired impact, since such companies would incur this level of expenditure regardless of the cap's setting;
- The \$100M cap should be restored, with the savings then used to increase the tax savings available to companies in the first tier of intensity who would be more responsive to the tax benefit.

Alternatively, companies that are likely to have eligible R&D expenditure in excess of the current \$100M cap could be required to justify why they should be allowed to claim an additional \$50M. This could be administered through a process similar to a finding, which may assess whether the proposed expenditure in excess of the cap has sufficient beneficial spillovers.

***Application of Intensity Threshold for companies with group turnover greater than \$20M***

Swanson Reed has significant concerns about the introduction of the intensity threshold which have been outlined in our previous submissions.

While we are happy that a \$0.04 minimum base level of R&D Offset entitlement remains for claimants of the non-refundable R&D Tax Offset (as opposed to the original recommendation during the R&D Tax Incentive review process that entities having less than 2% Intensity receive no R&D tax benefit), we are concerned the first tier of offset is less than half of the existing \$0.085 base level of R&D Offset entitlement.

Swanson Reed has also identified a number of issues with the calculation of the R&D Intensity that leads to complexity and unintended distortions.

**Definition of Total Expenditure:**

We note that total business expenditure is to be based on the total expenditure of the claimant, as per their tax return.

Calculating the intensity threshold in this manner would lead to distortions across industries, meaning the relative R&D benefit available to one industry may drastically vary to another. For example, companies in industries that have large total business expenditure, such as those with high-cost, Australian-based manufacturing operations would be unduly harmed under the proposed changes relative to those in other industries such as ICT. An Intensity Threshold would require such companies to incur greater amount of eligible R&D expenditure before qualifying for an equivalent rate of R&D tax benefit. This would lead to distortions in the level of incentive offered to certain industries, which reduces a key programme benefit of broad-based access.

Potential Mischief:

Introduction of the Intensity Threshold may lead to potential unintended consequences of companies artificially increasing their expenditure, or lodging aggressive claims to attain offsets under the higher tiers of intensity.

Total Business Expenditure based only on R&D Entity:

We note that total business expenditure is to be based on the total expenditure of the claimant, as per their tax return, and would not include the total business expenditure of affiliate or connected entities.

Without a grouping provision (similar to the rules prevailing for determining group turnover for eligibility of the Refundable Offset), distortions may be created. For example, a large company conducting activity through a consolidated entity would derive a lower R&D tax benefit than a large company that conducts R&D activity primarily in a subsidiary of a larger group. This may also lead to contrived business structures seeking to take advantage of the lack of a grouping integrity provision on this matter.

Uncertainty of total expenditure and intensity impairs investment decisions:

A key component of the design of the R&D Tax Incentive is for companies to be able to decide to undertake R&D activity that they may not otherwise conduct based on the legislated availability of tax benefits.

Given that a company may not be able to adequately forecast its total business expenditure at the time an R&D Investment decision is made, the Intensity Threshold compromises a company's ability to predict its R&D tax benefit for multi-year projects.

This may jeopardise a company's confidence to make a positive long-term investment decision due to the uncertainty of the R&D tax benefit.

Progressive deterioration of R&D tax benefit:

We also note that the introduction of the Intensity Threshold will represent yet another decline in the legislated R&D Tax Offset entitlement which reduces:

- The confidence of local companies to undertake long-term R&D activity;
- Australia's attractiveness as a destination for global companies to undertake R&D activity.

Since the introduction of the R&D Tax Incentive in FY12 offering a \$0.10 tax saving for large companies, there have been multiple reductions, including:

- \$100M Cap on annual expenditure (*The Tax Laws Amendment (Research and Development) Bill 2013*);
- Reduction in the tax saving for non-refundable offsets from \$0.10 to \$0.085 (*Budget Savings (Omnibus) Bill 2016*);
- Intensity threshold reducing tax saving for non-refundable offsets from \$0.085 to \$0.04 for companies with intensity less than 2% (*Treasury Laws Amendment (Research and Development Incentive) Bill 2018*).

Swanson Reed is of the view that an Intensity Threshold would reduce the willingness of large companies to undertake R&D activities due to the increased complexity and lack of confidence in the availability of R&D Tax Incentives. In a globally competitive market, Australia must retain an attractive, stable and broad-based R&D Tax Incentive to encourage large companies to conduct and maintain their R&D activities within Australia.

We would encourage the government to consider the following proposals in respect of the Intensity Threshold:

- Reconsider the introduction of an Intensity Threshold altogether, as such a measure drastically increases the complexity of the programme and reduces the incentive of companies to conduct R&D activity;
- If an Intensity Threshold is to be introduced, consider:
  - Increasing the first tier level of intensity premium from \$0.04 to \$0.06 or higher;
  - Implementing a grouping provision for the determination of an entity's total business expenditure which would partially offset the cost of increasing the first tier level of intensity premium.

***Proposed change to Feedstock Adjustment and Clawback***

We understand that the intent of the proposed changes to the feedstock and clawback provisions are to limit the incentive component of a company's R&D Tax Offset where:

- A government grant is received to fund the relevant R&D expenditure; or

- An amount of assessable income is derived that may be related to the relevant R&D expenditure.

We note that the proposed amendments and examples within the explanatory memorandum are complex and would recommend that additional and clearer guidance material on the proposed changes to feedstock and clawback provisions be published.

***Increased resourcing to programme administrations (ATO and AusIndustry)***

Swanson Reed supports the proposal to increase funding to the ATO and AusIndustry for compliance and guidance.

In respect of funding for additional guidance material:

- The case studies previously published by AusIndustry are generally quite helpful in communicating the scope of eligibility activities to companies. Further material could be published to provide additional examples of activities that are, and are not eligible;
- The ATO's fact sheets are generally helpful. Consideration should be given for providing resources for the reintroduction of the ATO's Innovation Tax support service. When previously operational, this facility was valuable for assisting companies and tax agents resolve technical issues arising from complex R&D Tax-specific matters that general ATO support staff may not be able to sufficiently answer. Given that some of the proposed amendments to the R&D Tax Incentive are complex, additional support may be required by companies and tax advisors during the transition.

In respect of funding for additional compliance activity:

- Swanson Reed supports measures that enhance and maintain the integrity of the R&D Tax Incentive;
- Swanson Reed would encourage a review of compliance processes be undertaken to allow companies conducting eligible R&D activities, though who may have received poor or no advice, to have better opportunity to rectify compliance issues. We are regularly approached by companies who are well advanced in compliance processes, yet appear to be conducting eligible R&D activity. The predicaments these companies are found in can often be attributable to them receiving poor advice and the compliance processes can sometimes be fatal to their company, or may leave them too traumatised to consider accessing R&D entitlements in future. We would wish to see a more collaborative approach in such warranted cases to allow companies conducting eligible activity better opportunity to become compliant, whilst suitably repairing previous shortcomings in their claims.

Swanson Reed also recommends the introduction of a dedicated R&D Tax Agent qualification for specialist advisors or accountants providing R&D tax services. This would mandate specific

professional and experience standards, rendering advisors better qualified to advise on the intricacies of the R&D Tax Incentive, in addition to the current standards under the *Tax Agent Services Act 2009*.

Given that the growth of the programme has largely been attributed to marketing by advisors, such a qualification may ensure new entrants to the programme are receiving suitable advice on their entitlements. Such a qualification would also provide AusIndustry/ATO a dedicated platform to communicate programme updates and professional expectations.

***Public Register of Claimants:***

Swanson Reed supports the release of an annual register of programme claimants, similar to that published by AusTrade for claimants of the Export Market Development Grant (EMDG).

Details to be published on such a register must be suitably moderated to protect any sensitive tax or intellectual property information.

***Measuring the Budget Cost of the Refundable R&D Tax Offset:***

As highlighted in our original submission, we have significant concerns that the cost of the Refundable R&D Tax Offset is overstated and based only on the *temporary* cash outlay, which is a key design feature of the programme.

We recommend that the cost of the Refundable R&D Tax Offset be calculated based on the *permanent* effect on corporate tax receipts and reduce emphasis on temporary financing benefits from factors such as:

- The forfeiture of tax losses for R&D expenditure claimed under the Refundable R&D Tax Offset. These forgone tax losses have the effect of ‘bringing forward’ corporate tax payments of claimant companies;
- Other timing adjustments arising under the R&D Tax Incentive, such as:
  - Feedstock adjustments taken up in subsequent periods;
  - Impact of dividend franking constraints arising from the claiming of R&D Tax Offsets.

An appropriate metric should be included within the cost measurement to recognise that many claimants of the programme will fail and, hence, never make use of the tax losses forfeited from their Refundable R&D Tax Offsets.

The Refundable R&D Tax Offset must, however, be costed appropriately if changes to the programme are to be considered on the basis of sustainability and cost.



## Conclusion

In summary, we wish to reaffirm the importance of a commitment to the stability of the R&D Tax Incentive.

Innovation policies and incentives have been subject to an ongoing series of reviews and proposed changes over the past decade. While such reviews have led to the introduction of the superior R&D Tax Incentive as successor to the R&D Tax Concession, a period of stability must now prevail.

There may be opportunity to enhance the efficiency of the R&D Tax Incentive; however, any changes must not adversely impact the fundamental structure of the programme, which provides a broad-based, easily accessed and significant incentive.

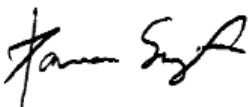
This is particularly the case as scarce R&D capital is increasingly mobile, and there is intensifying global competition for R&D investment by other jurisdictions offering generous and stable incentives.

Changes should also not be introduced that may make the programme seem too complex or hard to understand, and hence deter potential eligible participants.

We also wish to re-emphasise our concerns that the programme cost figures within the Issues Paper from the original Review appear to be significantly over stated given the apparent failure to consider forgone tax losses from refundable offset claims. The basis for determining the budget cost of the R&D Tax Incentive must be carefully examined, so as to measure the true cost and benefits of the programme.

Please do not hesitate to contact us on (07) 3221 1499 if you would like to discuss any aspect of this submission.

On behalf of Swanson Reed:



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